STAMP & RETURN

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CC Docket #96-98
CCB/CPD 97-30

SBC

EX PARTE OR LATE FILED

July 24, 1998

Memorandum of Ex Parte Communication

RECEIVED
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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Magalie Salas
Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Ms. Salas:

Re: *CCB/CPD 97-30 – Request by ALTS for Clarification of the Commission's Rules Regarding Reciprocal Compensation for Information Service Provider Traffic*

Yesterday the attached material associated with the above-listed proceeding was delivered to Mr. Kevin Martin, Legal Advisor to Commissioner Furchtgott-Roth. We are submitting the original and one copy of this Memorandum to the Secretary in accordance with Section 1.1206(b)(2) of the Commission's rules.

Please stamp and return the provided copy to confirm your receipt. Please contact me at (202) 326-8889 should you have any questions.

Sincerely,

Jay Bennett

Attachment

cc: K. Martin (w/o attachment)

LEGG MASON

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Scott C. Cleland
June 24, 1998

Reciprocal Comp For Internet Traffic--Gravy Train Running Out Of Track

(Part V of Internet Regulation Preview Series)

Summary: In a classic case of what you see is not necessarily what you get, **investors should not expect the current reciprocal compensation arrangement for Internet traffic to continue much past the end of the year.** Given that this issue is probably the single greatest opportunity for arbitrage in the whole sector, over 4,000 percent in some instances, **TPG cautions investors that this extraordinary arbitrage "gravy train" will run out of track--probably this year.** It is simply not sustainable long-term.

Moreover, investors should not be lulled into a false sense of security that 19 consecutive state public utility **commissions** have ruled (in addition to a recent Federal Court in Texas) that Internet service provider (ISP) traffic passed through a competitive local exchange carrier (CLEC) is classified as a local call. In the coming months, **TPG expects the FCC to trump these state decisions by clarifying that Internet traffic is indeed interstate, effectively reasserting its federal jurisdiction over data or Internet transport.** *(Reciprocal compensation is a regulatory arrangement where local telecom providers pay each other for "the cost" of terminating the calls they originate. In most cases, reciprocal compensation traffic is two-way and thus largely offsetting. However, since Internet/data traffic is one-way, there is little "reciprocal" about this arrangement. It is just a regulatory compensation windfall for CLECs/ISPs.)*

A Big Deal for Investors: This reciprocal compensation arbitrage is **a significant part of the existing "data growth engine" of many CLEC and ISP business models.** Consequently, investors need to be aware that in some instances, short-term projected results may be **artificially "juiced up," potentially providing an illusion of faster-than-real long-term growth.** The flip side of this problem is that reciprocal compensation is a **significant and growing liability, primarily** for the Baby Bells. It is growing at such a rapid rate that it could be a significant threat to earnings roughly in 1999, if not fixed by the FCC by then.

Why the FCC Will Fix It: First, reciprocal compensation for one-way internet traffic is arguably the single greatest **arbitrage opportunity and hence market distortion in the telecom sector today.** TPG flagged this important issue in our April 6 *"Internet Regulation Preview"* bulletin as akin to a broken bank ATM machine that only allows withdrawals and takes no deposits. No other place in the sector can companies reap as much as a 4,000 percent arbitrage for minimal, value-added service. No competitive market, legal or illicit, can generate such gargantuan arbitrage. Only regulatory distortions can generate this size arbitrage over an extended period of time.

Second, this arbitrage opportunity is **greatly contributing** to an ***artificial misalignment of the market*** structure of this newly emerging competitive voice/data niche. Reciprocal compensation is driving many alliances, mergers and acquisitions for purely regulatory and not economic or competitive reasons. Thus, in some instances, an ISP is currently an asset to a CLEC, but could become a serious liability without the arbitrage of reciprocal compensation. Third, it **discourages economically sound facilities-based local investment and inhibits the development of an efficient competitive market.** It has the perverse effect of turning customers from assets into liabilities. Why would any competitor want to win a customer if that customer would cost them more in reciprocal compensation terminating minutes than they could earn in revenue from that customer?

What to Expect From the FCC: Investors need to appreciate that it is **not that hard for the FCC to fix this in the coming** months. ALTS, the association representing the CLECs, has an active petition (dated June 20, 1997) requesting that the FCC issue a clarification that the traffic in question is local and not interstate. ALTS argues in its petition that "this clarification is clearly in the Commission's (FCC) exclusive jurisdiction." For FCC legal authority, ALTS cites a 1980 Computer II FCC decision which was subsequently upheld in the DC Court of Appeals in 1982 and again in 1984. Now that the states have ruled the CLECs' way, the association likely regrets having requested this clarification from the FCC.

Why would the FCC believe such Internet calls are not local but interstate? The FCC has exempted this traffic from interstate access charges for over a decade. Why would an exemption from interstate access charges be needed if the FCC thought it was a local call? Moreover, in the FCC's April 10 report to Congress, (paragraph 106) the FCC said that ISPs "are not entitled to reciprocal compensation for terminating local telecommunications traffic." However, the FCC explicitly did not comment on whether CLECs that serve ISPs are entitled to reciprocal compensation for terminating Internet traffic. They said that issue was now before the FCC. * * * * *

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Precursor Research™
Scott C. Cleland
March 18, 1998

Testimony Before Senate Communications Subcommittee on Telecom Act

(4 pages)

Written Testimony of Scott C. Cleland, delivered March 18, 1998, before the Communications Subcommittee hearing of the United States Senate Committee on Commerce, Science and Transportation on "Wall Street Perspective Of 1996 Telecommunications Act Implementation."

Mr. Chairman, thank you for the honor of testifying before your Subcommittee on behalf of the Precursor Group℠ of Legg Mason Wood Walker, Inc. on the very important topic of the financial markets' perspective of implementation of the 1996 Telecommunications Act.

I offer the following insights and observations on the implementation of the Telecom Act in hopes that these will be useful to the Subcommittee.

I. Effect on Financial Markets

In general, financial markets dislike competition and uncertainty. "Large Cap" investors, which control the overwhelming majority of money managed in the United States, don't like the prospect of increasing competition because it creates uncertainty about future profit margins. For these investors in the most widely-held companies, the "competition" rhetoric from Washington generally frightened them and caused them to spend an enormous amount of time "war-gaming" out various competitive scenarios. On the other hand, investors in small companies and startups cheered passage and implementation of the Telecom Act because of the new opportunities it afforded.

However, the enormous confusion and uncertainty that have emerged from the legal fight over the implementation of the Telecom Act has served no one well. After years of uncertainty over the new rules of competition and subsidies, I am beginning to detect that the markets are increasingly "numb" to regulatory and legal developments. There is a growing mood of "wake me up when something really happens in the marketplace."

II. Problems With Telecom Act Assumptions

It is increasingly apparent that many of the problems with the implementation of the Telecom Act are actually serious problems with some of the core assumptions underpinning passage of the Telecom Act.

A. *Overly Optimistic Technology Assumptions:* The Telecom Act apparently assumed that technology had advanced to the point at which there could be an *economically viable* and *widespread* facilities-based alternative to the local voice infrastructure in the reasonable future. As it turns out, the cable industry grossly over-promised on the viability of its infrastructure as a direct replacement to the copper voice architecture. Also greatly over-hyped was the *reliability* of wireless technology *at a replacement price*; that prospect is still a few years off at least and then probably will only begin as a niche service.

Much of the bitter legal and regulatory struggle that has transpired over the last two years may be rooted partly in this incorrect core assumption. Regulators are dutifully and desperately trying to cram **the Telecom Act's "two-pipe policy" into what remains a predominantly "one-pipe world"** for the foreseeable future.

B. *Natural Monopoly?* The Telecom Act's optimistic technological assumptions have fueled conventional wisdom that the local loop voice architecture is no longer a "natural monopoly." However, it appears that local telephone service may still be a natural monopoly, meaning that the enormous capital cost of replicating local infrastructure suggests that consumers can get a better rate from one regulated provider that enjoys the full benefits of economies of scale. In addition, the 1934 policy of universal phone service and the 1980s subsidies of local service through inflated long distance access charges have resulted in roughly 94% of Americans enjoying near-perfect local residential dialtone service substantially below real cost.

However, unless we see a dramatic technological breakthrough which lowers the price of alternative local architectures, I believe that for at least 80-90% of American consumers, local phone service will remain a "natural monopoly" for another five years — maybe longer.

But What About Existing Local Competition? The local competition that exists now, or is developing, almost exclusively benefits big business and not residential consumers. There remains very little prospect for widespread residential competition in the foreseeable future. Current local competition is fueled by subsidy-price arbitrage. If local monopolies were allowed to offer their business customers service at a "competitive" rate—i.e., closer to their cost—most existing local competition would vanish overnight. Policymakers should understand that current local business competition is fueled predominantly by three factors:

- *First, there is huge subsidy-price arbitrage.* The business rate "umbrella" for local service is still substantially inflated in relation to cost because regulators have chosen to cross-subsidize residential service with high business rates. Thus current competitors enjoy regulatory-imposed inflated prices without paying the offsetting regulatory-imposed extra costs of subsidies. What is really going on is less about competition (as most businesses know it) and more about politically reallocating residential subsidies to CLEC shareholders. What we have now is competition for governmental subsidies.

- *Second, there is simple "cream-skimming."* New competitors can target their capital investment with laser-like efficiency on only the low-cost, high-volume customers. In other words, in the current policy vacuum of no new explicit universal service system, local competitors can serve only the best customers without having to pay for the less profitable customers it leaves behind. We are currently in a "free-lunch" transition period for competitors, in which they get only the best of the old subsidy system and don't have to factor in all of the hidden future liabilities in the new explicit system. In addition, the current practice of CLECs aligning with Internet service providers (ISPs) to take advantage of two-way voice reciprocal compensation arrangements for data traffic that largely flows only one way is the policy equivalent of a "broken ATM machine" giving away money to whomever plugs into it. This transitional "loophole" benefit to current nascent competitors is not, in my opinion, sustainable long term.

- *Third, money is extraordinarily cheap right now.* The current booming economy and low inflation make it relatively easy for most business proposals to find capital.

C. *Competition and Universal Service Compatible?* The Telecom Act assumes that competition and universal service are compatible goals. While they are definitely both laudable and outstanding policy goals, *in practice* they are not complementary goals. In fact, they are probably much more directly contradictory than most will publicly admit. The FCC euphemistically refers to these goals as being in "dynamic tension" with one another. Unless regulators perfectly balance everything and the courts stay out of the way, either universal service will end up undermining competition, or competition will end up undermining universal service. Profit maximizers simply do not want to serve unprofitable customers unless they have to. Currently, prices are set politically — not by market forces. If competition ultimately eliminates subsidies, then American residential consumers' rates are going up — probably by a lot.

D. ***Can Competition Develop In Advance Of Subsidy Reform?*** The Telecom Act directed the FCC to begin promoting competition before reforming subsidies. This implementation sequence is backward. Like a breech birth, there is great risk that local competition could be stillborn because of the backward implementation sequence. How can a "competitive market" be created and thrive when prices bear little relation to cost and the outlook for reforming the pricing structure is so completely uncertain?

E. ***Telecom Policy Moved From the Courts to the FCC and States?*** Congress assumed that by removing Judge Greene and the Modified Final Judgment of the AT&T Consent Decree from the telecom policy making process that the states and the FCC would determine final telecom policy. It hasn't turned out that way. One court has been replaced by multiple courts.

With "20-20 hindsight," it shouldn't be surprising that, in an artificial market where the government sets prices and has created competition for off-budget subsidies, every party would go to court to keep or get "theirs." Virtually every substantive policy dispute is being litigated: federal-state jurisdiction, constitutionality, pricing authority, unbundled element interpretations, subsidy reform issues, etc. The Telecom Act has unleashed a lot of conflict without spelling out exactly how to resolve it. The current litigating trend will probably only get worse as subsidy reform heats up and as the Internet (which knows no jurisdictional boundaries) becomes more mainstream.

III. Problems With Telecom Act Implementation

A. ***The Politics of "Telecom Tic-Tac-Toe":*** As is commonly understood, the game of "tic-tac-toe" is so simple, that two sophisticated players will always play to a draw. That's because it is so easy to block your opponent from winning. Implementation of the Telecom Act is a lot like a game of "telecom tic-tac-toe." No one is going to "win" and the game will continue to be played to draws because it is so easy to block the other side from gaining a permanent winning advantage. Apparently the markets have become intuitively accustomed to this game, realizing that the result of this repetitive blocking game is "the triumph of the status quo."

B. Local Competition and Bell Entry Into Long Distance: While Congress, regulators, and the markets thought there would be more local competition and Bell entry into long distance than there is now, it hasn't worked out that way for many of the reasons outlined above. The sector is essentially in a status quo "holding pattern" that will continue for about a year or more awaiting resolution from the Supreme Court on the validity of the FCC's local competition rules, and the constitutionality of the Bell-specific provisions of the Telecom Act.

It is becoming increasingly apparent that in the next couple of years we will not see much widespread local *competition beyond the business market in the big cities*. Unless there is a technological breakthrough lowering the cost of alternative service, or most state regulators rebalance rates by substantially raising residential local rates, local competition in 90% of the residential market will be stillborn.

As for Bell entry into long distance, it is very unlikely that we will see the FCC approve a Bell entry application for long distance in 1998 and probably not in 1999, because it is increasingly apparent that the FCC and the Justice Department have a very tough standard of what an "open local market" means. While the Clinton Administration supported the Telecom Act, it is no secret that the Administration was less than enthusiastic about the prospect of loosening the standard for allowing Bell entry into long distance. So it should not come as a big surprise that while the law changed the procedure for reviewing Bell entry, the Administration did not change its implicit standard for Bell entry. It appears that the Administration believes that "open for competition" still means the old Judge Greene "8c" standard, that *"...there is no substantial possibility that it could use its monopoly power to impede competition in the market it intends to enter."*

Moreover, it is pretty clear that the FCC does not view Bell entry in the public interest because it is implementing the checklist under the tacit assumption that the Bells will abuse their market power unless regulators can prevent any and every potential way the Bell could leverage their monopoly position. The only way I see broad-scale Bell entry into long distance in this century is if the Telecom Act is ultimately ruled unconstitutional by the court, which, by the way, is much more of a wildcard possibility than conventional wisdom suggests.

C. The "Catch-22" of Widescale Broadband Investment: Apparently the primary way regulators know to encourage local competition is to restrain the incumbent monopolies from exercising their market power. This approach assumes that if only the incumbent monopoly can be prevented from blocking competition, then competition will flourish. (Never mind the fact that most consumers currently get their local service far below cost – arguably a long-standing anti-competitive political decision.)

However, the ripple effect of this policy approach to local competition is to tacitly discourage local loop investment upgrades by the incumbent as anti-competitive. The regulatory logic apparently is that a new competitor compete cannot compete if a monopoly is unfettered to offer improved broadband service? The unintended but practical result of this approach is that the government has created two classes of investment: investment by competitors that is welcome and good; and investment by monopolies that is bad, anti-competitive and essentially an unfair cross-subsidy that needs to be stamped out.

The *"Catch-22"* of this policy approach is that fairness to competitors takes precedence over fairness to consumers. Therefore, consumers must wait for competitors to offer them broadband services – which is unlikely to occur in most consumer markets because current local service is offered below cost for political reasons. This is partly why two years after the Telecom Act, consumers are still screaming "where's my promised new bandwidth?"

The *"Catch-22"* is the fact that the current local policy holds the vast majority of the nation's hundred-million subsidized consumers hostage to competition that won't be showing up in their neighborhoods anytime soon. Like a cruel joke, at least 80 million American households are being left "on hold" waiting for a "competitive" rescue that no competitor plans to launch in the foreseeable future.

Moreover, the current regulatory approach of insisting on unbundled resale at rates that guarantee competitors a profit powerfully discourages investment by everyone involved. Why should competitors put capital at risk if they can lease at a guaranteed profit? (With the breakup of AT&T, the government guaranteed competitors *non-discriminatory access* to AT&T's network, *not access with a guaranteed profit for competitors*.) Why should incumbents invest in upgrading the local loop if a competitor can resell it for less than the amount necessary to recover the original cost of the investment? This perverse disincentive works like a "reverse patent," where only the competitor profits from innovative investment upgrades, not the original investor.

D. ***Two Classes of Telecom Citizens?*** Value judgments aside, the Bell entry language in the Telecom Act and the FCC's implementation of it also has de facto created two separate classes of American citizens, a regulatory distinction that no average American citizen would understand if explained.

- One class of citizens includes those roughly 20 million American households that have an incumbent phone company which can offer local, long distance and full Internet services. These roughly 50 million Americans either enjoyed that benefit before the Telecom Act passed (like Sprint customers) or were granted that benefit by Congress when the Telecom Act allowed GTE immediate entry into long distance in February 1996.

- A second class of citizens includes about 80 million households, or over 200 million Americans, who by quirk of geography or chance, were part of the old AT&T system and are now served by a Baby Bell. These consumers do not enjoy the benefit of an incumbent provider that can provide local, long distance and full Internet services. The Telecom Act created a now well-known separate process whereby a Bell must apply to the FCC after meeting a separate "competitive checklist" on a state by state basis before being able to offer long distance and full Internet service to its customers. These 200 million American citizens, only because of where they live, have to wait for the Bells and the FCC to break their regulatory stalemate before they enjoy the same regulatory treatment as the other roughly 50 million Americans. The practical result is different regulatory treatment. These 200 million American consumers will have one less communications alternative than their non-Bell brethren, and could enjoy substantially less broadband investment than their non-Bell brethren.

E. ***Why The Subsidy Pie Will Grow:*** In contrast to conventional wisdom, it appears that telecom subsidies will grow rather than decrease over time as most expect. And unfortunately it looks as if consumers will end up paying for the increased subsidies unless a major change in the current dynamic occurs. The politically unintended end result where the consumer gets stuck with an increasing subsidy bill is likely for several reasons:

- *First*, it is much easier politically to add subsidies than it is to cut them. (Exhibit I: last May, after the FCC was lobbied furiously for months to slash cut local access charges by $10 billion, the FCC cut them ZERO in its access charge order out of fear that local rates would rise. On that same day last May, the FCC created $2.65 billion in new subsidies to fund Internet discounts for schools, libraries and rural health care. While the FCC thought that the price cap reductions it also ordered that same day would pay for the new subsidies, it hasn't worked out that way. There is currently a lot of finger-pointing going on among the FCC, long distance carriers and the local telcos about whether consumers are actually getting the full benefits of the May reductions in the price caps.)

- *Second*, many in and outside industry have sized up the estimated $20 billion plus in implicit telecom cross-subsidies as an off-budget "piggy bank" to be raided because it is largely unaccounted for and not well-understood by anybody. Consequently, there are a growing number of ideas to spend and re-spend this "new-found" money.

- *Third*, unlike the budget deficit, there is no official or widely accepted method of accounting for these telecom subsidies, and there is unlikely to be any good accounting anytime soon. That's because while the Telecom Act gives the FCC primary jurisdiction over *future* universal service funding, the *existing* system of subsidies is mostly controlled by the 50 states. And that's also because precious few individuals outside the big telecom companies truly understand the full intricacies of the arbitrage or business value of the various arcane subsidies.

- *In sum*, I fear telecom subsidies will grow because it is the path of least political resistance; because targeted, powerful corporate interests overwhelm the diffuse and outgunned consumer interests; and because no one is running a tab on the overall cost. It's just a bunch of receipts sitting in different bureaucratic drawers somewhere.

F. ***1980s' "Win-Win" Situation Makes Future "Lose-Lose":*** The breakup of AT&T spurred decreasing long distance prices. Regulators were able to add inflated long distance access charges to the decreasing long distance rates to keep local rates low. No consumer noticed because, due to the per-minute nature of long distance rates, long distance bills fluctuate. This was a political "win-win" situation. Now the Telecom Act has unleashed forces that threaten to turn that "win-win" into a "lose-lose" political situation. As competition siphons off or erodes subsidies, governments must either increase subsidies more or let local rates rise -- which, because of their flat-rate nature, consumers will notice and will not like.

* * * * *

Teleport reports first quarter results. Teleport Communications Group, currently in the process of merging with AT&T, announced quarterly results that included normalized EBITDA of $22.2 million and revenues of $160 million. The results are up significantly from Teleport's first quarter 1997 figures of $6.1 million EBITDA on revenues of $96.8 million. Teleport added approximately 43,000 access lines during the first quarter and now has more than 325,000 access lines in service.

Industry Events

Bell Atlantic addresses reciprocal compensation. In order to prove that it should not have to pay reciprocal compensation fees for calls to Internet service providers served by CLECs, Bell Atlantic Corp. is installing monitoring technology that will allow it to differentiate between voice and data traffic terminated on CLEC networks. The company estimates it will pay over $150 million during 1998 in reciprocal compensation fees to CLECs for the termination of ISP traffic. State regulators have generally held that calls to ISPs are local and therefore are subject to the reciprocal compensation arrangements in local network interconnection agreements. Many CLECs have enlisted ISPs as customers, and several ISPs have become CLECs themselves, in order to collect the large reciprocal compensation fees from the ILECs.

MCI and WorldCom to respond to European antitrust concerns. MCI and WorldCom will be given the opportunity to respond to objections to their proposed merger during two days of hearings scheduled for May 12 and 13 at European Commission's offices in Brussels. The EU inquiry into the merger, which centers on the two companies' share of the world market for the supply of Internet backbone services, is scheduled to end by July 14. The U.S. Department of Justice is also examining the possible impact of the merger on the long distance resale market.

CLEC Company Events

Birch selects vendor for switching equipment. Birch Telecom has signed a five-year deal with Lucent Technologies, hiring Lucent to be its sole provider of switching hardware and software. Under terms of the contract, Lucent will supply Birch with 5ESS switching systems and power equipment as the carrier prepares to launch services in Kansas City and St. Louis. Birch also plans to deploy equipment in other communities throughout the Midwest, and says the value of the contract could exceed $50 million over the next five years.

ELI completes Northwest long-haul link. Electric Lightwave Inc. has completed a 569-mile, long-haul fiber optic route between Portland, Oregon, and Spokane, Washington. The company is also planning another 300-mile fiber link between Spokane and Seattle. Meanwhile, ELI has opened its Spokane sales office and expects to turn up its own switching platform there by the end of the summer.

Hyperion selects call-intercept units from ETC. Hyperion Telecommunications plans to install Digicept 2002 units made by Electronic Tele-Communications Inc. The units, which provide prerecorded messages informing callers of changed or disconnected numbers and other dialing information, are to be installed at 12 Hyperion sites across the country.

ICG completes private placement. ICG Communications Inc. has completed its previously announced private placement of $250 million worth of senior discount notes. The 9.875 percent notes mature in 2008 and pay no interest in cash for the first five years.

CLEC Matrix: Weekly Update

February 9, 1998

Earnings Models

Telecommunications - CLECs

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- **With the quarterly reporting season upon us, we have provided our financial models for the various CLECs in our universe.**
- **The FCC rejected BellSouth's application to provide long-distance services in the state of Louisiana.**
- **The Texas Public Utility Commission ruled that SBC must pay the CLECs for terminating Internet traffic (reciprocal compensation).**
- **Metromedia Fiber Network announced another significant contract by which the company will provide dark-fiber capacity to a major financial institution.**

The attached pages represent the weekly update to our CLEC matrix. Highlights during the past week include:

- Following the Department of Justice's (DOJ) earlier evaluation and recommendation, the Federal Communications Commission (FCC) rejected BellSouth's 271 application to provide long-distance services in the state of Louisiana. Similar to its decision with BellSouth's 271 application in South Carolina, the FCC cited that the company had not demonstrated non-discriminatory access to its operational support systems (OSS) to local competitors. In addition, the order also cited that BellSouth's refusal to offer contract service arrangements for resale at a wholesale discount had violated specific 271 requirements. Keep in mind that in October 1996, the Louisiana Commission set a 20.72% wholesale discount rate. It is interesting to note that although the Louisiana Commission approved BellSouth's long-distance application, citing that the company has demonstrated adequate access to its OSS, three other BellSouth states, Florida, Georgia, and Alabama, have determined that access to BellSouth's OSS was insufficient.

- The Texas Public Utility Commission ruled that Internet traffic is, in fact, local traffic and therefore subject to the reciprocal compensation rules. With this decision, SBC is now required to pay the CLECs for terminating Internet traffic. Texas represents the twelfth straight state victory for the CLECs with respect to gaining reciprocal compensation for internet traffic. SBC had withheld reciprocal compensation payments, arguing that Internet traffic should be classified as interstate traffic. Although the Texas PUC ruled that SBC must honor its existing contracts with its competitors, the commission will further review this issue in future meetings. Reciprocal compensation for Internet traffic will be a key issue for both the CLECs and ILECs as many of the remaining states address and rule on this issue. None will be more important than the PUC's decision in the state of California.

TeleFOCUS

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BULLETIN*

June 23, 1998

COURT REJECTS SBC REQUEST FOR INJUNCTIVE RELIEF
AFFIRMS THAT CALLS TO ISPS ARE LOCAL AND ORDERS COMPENSATION

On June 16, 1998, Senior U.S. District Court Judge Lucius D. Bunton, III of the U.S. District Court for the Western District of Texas (District Court) denied **Southwestern Bell Telephone's** (SWBT) request for declaratory and injunctive relief against the Texas Public Utility Commission (PUC). SWBT is a subsidiary of **SBC Communications** (SBC). SWBT filed suit on March 19, 1998, appealing the PUC's February 27, 1998 order that: (1) classified calls to Internet Service Providers (ISPs) as local calls; and, (2) declared SWBT's interconnection agreement with **Time Warner Communications** (TWX) to be valid, and required SWBT to compensate Time Warner for terminating calls to Time Warner's ISP customers. In its suit, SWBT contended that: (1) the PUC did not have jurisdiction to approve an interconnection agreement "involving connections to ISPs"; (2) connections to ISPs are interstate calls subject to the Federal Communications Commission's (FCC's) jurisdiction; and, (3) the Texas PUC erroneously found that SWBT's interconnection agreement with Time Warner included reciprocal compensation rates for connections to ISPs. The PUC ordered SWBT to prospectively pay ISP-related reciprocal compensation to Time Warner, was well as retroactively, with interest. In an April 1, 1998 application with the District Court for a preliminary injunction against the PUC's order, SWBT alleged that the ruling would amount to $400,000 of monthly losses and as much as $60 million of unrecoverable losses in the coming year, if other competitive local exchange carriers (CLECs) invoked the Time Warner ruling, either as precedent or through "most-favored-nation" rights. *The ramifications of this decision could extend beyond the SBC-Time Warner spat, if other legal challenges to similar PUC rulings mirror the outcome of the instant Texas case. SBC has not yet indicated whether it will appeal the June 16, 1998 District Court order.*

The District Court concluded that the interconnection agreements between SWBT and Time Warner were "at the heart of the instant case" in that both companies are local service providers and need to interconnect physically and contractually to allow each others' customers to call one another. Two such agreements were negotiated between the two companies and submitted to the PUC for approval in July 1996, and August 1997, respectively. Importantly, both agreements were presented to the PUC with no outstanding issues requiring arbitration, and both agreements provided for reciprocal compensation for the transport and termination of local calls at an agreed to per minute rate. The agreements were approved by the PUC.

Although SWBT had sent letters to Time Warner during the negotiations of the second agreement stating that Internet calls were not to be considered local, neither agreement explicitly addresses Internet connections or even mentions the Internet. During negotiation of the second interconnection agreement

*This Bulletin was originally published as a FaxNote on June 22, 1998.

ISP customer of Time Warner. On October 7, 1997, Time Warner filed a complaint with the PUC alleging that SWBT's refusal to pay the reciprocal compensation represented a breech of contract. SWBT claimed that the PUC lacked jurisdiction over the ISP issue, as ISP traffic was interstate in nature and was therefore under the jurisdiction of the FCC.

On February 27, 1998, the PUC issued an order finding that calls to ISPs were local in nature when the ISP is in the local calling area, and that SWBT owed Time Warner reciprocal compensation for such calls. The decision was based on a finding that: (1) the PUC's decision is consistent with the Federal Telecommunication Act of 1996; and, (2) the PUC did not act arbitrarily and capriciously, without substantial evidence. The District Court, agreeing with the PUC and drawing support for its opinion from FCC orders, held that, although the Internet can be characterized as interstate in nature and may involve interstate commerce, Internet use is not a single end-to-end communication. Rather, as the FCC stated in its May 1997 Universal Service Order, Internet access consists of two parts "a network transmission component, which is the connection over a local exchange network from a subscriber to an ISP, in addition to the underlying information service." The District Court stated: "[T]he PUC, in the instant case, is not attempting to regulate the Internet. Rather, the PUC is merely regulating that which it has the power to regulate--the seven-digit local telephone calls that Internet customers make to 'dial up' their Internet Service Provider....The ISPs are merely business customers of the local exchange carriers which provide an information service via telecommunications."

Tom Fitzsimons

--SUMMARY:---

*The Michigan and Texas PUCs voted late last week that CLECs serving ISPs as customers are entitled to reciprocal comp. from Bells when Bell customers are dialing that ISP & thus terminate calls on a CLEC network.
*Big victory for CLECs as it sets precedents that suggest those ILECs who try to violate existing interconnect(IC)agreements & not pay CLECs recip. comp for calls terminated to ISPs will likely be overturned in other states
*This issue has exploded since the Bells had pushed for reciprocal comp.in interconnection agreements signed with CLECs over the past several years not realizing that ISP customers of CLECs would create a situation where the overwhelming balance of payments are flowing from ILECs/Bells to CLECs
*Crux of the issue is that existing ic agreements which include recip comp for calls to ISP pop must be upheld.

--OPINION:---

Late last week both the Michigan Public Service Commission and the Texas Public Utility Commission reaffirmed in a unanimous fashion that CLECs are entitled to reciprocal compensation payments from Bell companies for calls that originate from a Bell customer and terminate at an Internet Service Provider (ISP) point of presence (POP) which happens to reside on a CLEC switch. The reason this ruling came about is because the Bells tried to reneg on their interconnection pacts made with the CLECs and as a result of the ruling, owe retroactive payment of reciprocal compensation plus interest on these amounts. The Texas and Michigan Commissions said that legal interconnection agreements between Bells and CLECs are in fact binding and thus the Bells must adhere to all terms and conditions of these agreements including payment of reciprocal compensation. However, the bigger issue of whether ISP traffic is deemed local or not is still yet to be decided but it is basically irrelevant since virtually every interconnection agreement includes reciprocal compensation and does not exclude any class of local calling like calls to an ISP POP.

This is a big victory for CLECs and is likely to result in other similar disputes being settled in a favorable fashion to the CLECs. For a bit of context here, reciprocal compensation simply means that if a Bell customer calls a CLEC customer the Bell owes the CLEC a payment for terminating a call on the CLEC's network. Conversely, if a CLEC customer calls a Bell customer, that CLEC similarly owes the Bell payment for a call terminating on a Bell network. Typically these payments range in the $0.005-$0.008 per minute area. The alternative to this type of arrangement would be what is known as "bill and keep" which basically says whomever has the customer, be it the CLEC or the Bell, simply bills that customer and keeps all revenues without this type of reciprocal compensation arrangement.

Ironically, back in 1996 when interconnection agreements were being negotiated between Bells and CLECs, the CLECs pushed for bill and keep but it was the Bells who insisted upon this reciprocal compensation scheme. This made sense since in a voice world, the odds of a Bell customer terminating a call on a CLEC network seemed rather remote especially among residential users. Hence, the Bells pushed for and got reciprocal compensation rather than a bill and keep arrangement. However, what has occurred is that with the proliferation of ISPs most of whom seemed to be customers of CLECs rather than Bells, many Bell customers who call into an Internet POP find themselves terminating a call on a CLEC network. Moreover, given the lengthy connection time of most calls to an ISP the Bells are finding themselves watching the meter run on every call to an ISP POP and hence, are paying increasingly large amounts to the CLECs for [illegible] Intermedia because of their Netcom and DIGEX ownership, respectively, RCN due to their recent acquisition of Erols and UltraNet, as well as obvious big winner MFS/UUNET who has the largest Internet backbone.

The gist of the complaint by the RBOCs, most notably Ameritech, was that a call into an ISP was not in fact a local call but was in fact a long distance call since the caller--namely the user who is hooking up into the Internet-- is not really making a local call but rather utilizing a national platform--namely the Internet. However, the Public Service Commissions have decided that a call to an ISP terminating in the local calling area should be treated as a local call and therefore subject to reciprocal compensation to the ISP's CLEC service providers. These calls use 7 digit local numbers and are subject to local tariffs. Moreover, these calls are treated by the Bell as local calls for call rating, billing, reporting separations allocation, and most importantly, Bell interconnection agreements with the CLECs do not distinguish between local calls based on a type of customer at the terminating end, be it your sister or an ISP POP.

Since calls into an ISP do not relate to the termination or origination of long distance per se but rather access to content on the world wide web, these calls are decidedly local in nature. The Michigan PSC in particular questioned why Ameritech has not broadly implemented its policy position by declining to pay reciprocal compensation to non-Internet information service providers. In other words, if there is a local call into a local database that happens to be carried on a CLEC network, Ameritech has been and continues to pay reciprocal compensation.

The bottom line here is that the Bells in a sense out-smarted themselves, thinking a few years ago that the local calling world would be defined as it had been over the past 100 years--namely voice calls from one house to another or one office to another--thus their desire for a reciprocal compensation scheme. They clearly did not envision the explosion in ISP traffic nor did they realize that the vast majority of ISPs would end up CLEC customers rather than their own customers. Hence, the overwhelming balance of payment on reciprocal compensation for calls to terminate on an ISP network is flowing from the incumbent local exchange carriers or the Bells to the CLECs.

We believe these rulings, especially the one in Texas, a state that is viewed as decidedly pro-Bell sets the stage for a complete reaffirmation of the reciprocal compensation policies that say all local calls which are treated by the Bell in the same manner in terms of tarriffing and billing are subject to reciprocal compensation even if they are calls that go to an Internet POP. Of course, the problem from the Bell perspective is that calls into an Internet POP can last a long time and the meter is running for what the Bell owes the CLEC. We also believe the state's action on this is a harbinger of other potential actions such as common transport and unbundled network element combinations which the Michigan PSC has already decided that Ameritech must do despite the fact that the Eighth Circuit Court of Appeals ruled against the FCC on this.

NET/NET: We are not talking about big dollars here yet. From the CLECs perspective a source of revenue which is growing quite rapidly has now been reaffirmed and at the margin clearly is positive to the financial outlook of the industry. More importantly it is clear that state commissions are taking very seriously legal contracts between the Bells and CLECs may be saying.

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END OF NOTE